

SHARES OF THOROUGHBREDS AS SECURITIES: FEDERAL AND KENTUCKY SECURITIES LAW IMPLICATIONS FOR SYNDICATION IN THE BREEDING AND RACING CONTEXTS

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I. INTRODUCTION

The Kentucky Derby, the Preakness Stakes, and the Belmont Stakes—the three jewels of Thoroughbred horseracing’s Triple Crown.¹ These are the three races that exemplify the glamour of the industry in the United States. Most of the fans who attend those races—and indeed, who attend most races—come to the track simply to socialize, to watch the beautiful animals race to reach the wire first, and perhaps to bet a few dollars on their favorite horses. However, there are a smaller number of individuals who invest vast sums of money² to breed and race Thoroughbreds.

It is for these individuals—those involved in the investment of Thoroughbreds to breed and race—that this article is mainly written. Section II discusses the federal and Kentucky definitions of a security by reviewing the Securities Act of 1933 and the Kentucky Blue Sky Laws. The section also undertakes a review of the federal and Kentucky courts’ decisions to provide an understanding of an investment contract. The final aspect of Section II applies the federal and Kentucky tests for investment contracts to shares of syndicated Thoroughbreds to determine whether they can be considered securities. Section III begins by explaining the federal and Kentucky exemptions from the securities registration requirements as established in both

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¹ Of which there have been eleven winners, the most recent being Affirmed in 1978.

² In some cases, tens of millions of dollars.

the federal and Kentucky statutes and regulations. It then considers the effect those exemptions would likely have if they are applied to shares of syndicated Thoroughbreds in both the breeding and racing contexts. Finally, Section IV provides a brief concluding summary of the federal and Kentucky securities laws' impact on the syndicated shares of Thoroughbreds.

II. ARE SHARES OF SYNDICATED THOROUGHBREDS SECURITIES?: FEDERAL AND KENTUCKY TESTS FOR INVESTMENT CONTRACTS APPLIED TO SYNDICATED THOROUGHBREDS

This section lays out the definitions of a security and the registration requirements for those securities. It first reviews the federal definition of a "security" as defined in the Securities Act of 1933³ and then analyzes the federal courts' interpretation of the definition of an "investment contract" starting with the United States Supreme Court's decision in *SEC v. Howey*.⁴ It next completes the analogous process for Kentucky, looking at the Kentucky definition of a security as well as the Kentucky state courts' understanding of an investment contract. Finally, the section applies the federal and Kentucky tests for investment contracts to shares of syndicated Thoroughbreds in the breeding and racing contexts to determine whether those shares are securities.

A. *Federal Securities Laws and the Howey Test for Investment Contracts*

1. *The Securities Act of 1933: Definitions and Registration Requirements*

a. *Section 2(1): The Definition of a Security*

The first step in analyzing whether a share of a syndicated Thoroughbred can be considered a security—and therefore subject to securities laws registration requirements—is to know how the term "security" is defined by Congress and understood by the Securities and Exchange Commission (SEC). Section 2(1) of the Securities Act of 1933 lays out the specific definition for a security.⁵ That definition includes a very long and extensive list of items that constitute securities.⁶ Of course, the typical instruments such as "note[s], stock[s] . . . security future[s], bond[s], [and] debenture[s]" top the list.⁷ But the definition also includes, among many other

³ Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(a)(1) (2006).

⁴ Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293, 298 (1945).

⁵ Securities Act of 1933 § 2(1).

⁶ See *id.*

⁷ *Id.*

things, “fractional . . . interest[s] in . . . mineral rights.”⁸ Finally, the definition includes a catchall term, the “investment contract.”⁹

It is these investment contracts that are of critical importance to examining whether shares of Thoroughbreds can be considered securities because these types of securities are the ones under which the shares would most likely fall.¹⁰ Though an investment contract is not defined in the Securities Act of 1933, the United States Supreme Court has provided a test that sheds light on when certain business arrangements qualify as investment contracts subject to securities laws.¹¹ This test will be discussed below in Sections II-A-2 and II-A-3. If the arrangement does qualify as a security, then it is subject to the Securities Act registration requirements unless it is granted an exemption.¹² These federal exemptions will be discussed in Section III-A below.

b. *Section 5: Prohibitions Relating to Interstate Commerce
and the Mails*

Section 5 of the Securities Act is vitally important to the control of issued securities because it places limits on the methods of solicitation used to sell securities if there is no registration statement in place.¹³ Unless otherwise exempted, a security is subject to section 5’s registration requirements,¹⁴ and thus subject to federal securities laws. Section 5’s limits make it unlawful to use the instruments of interstate commerce or the mails to solicit the sale of or to sell securities unless the securities are registered.¹⁵ Moreover, the application of the different section 5 subsections is dependent on two specific events in the offering and selling process, namely, the time at which the registration statement is filed and the time at which it becomes effective.¹⁶

2. *The Howey Test for Investment Contracts*

After describing the federal definition of a security and the registration requirements under the Securities Act of 1933, the next critical aspect of this paper is to determine whether or not an interest—here, a share of

⁸ *Id.*

⁹ *Id.*

¹⁰ See *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8 (E.D. Ky. 1985).

¹¹ See *Sec. & Exch. Comm’n v. W. J. Howey Co.*, 328 U.S. 293, 301 (1945).

¹² *Id.* at 297.

¹³ Securities Act of 1933 § 5.

¹⁴ *Howey*, 328 U.S. at 297.

¹⁵ Securities Act of 1933 § 5(a)-(c).

¹⁶ LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 35 (2d ed. 2004).

a Thoroughbred horse—is a security. Because the investment contract is the type of security under which the share of a syndicated Thoroughbred will likely fall if it is to be a security,¹⁷ it is critical to understand what determines whether something is an investment contract.

Since the Securities Act leaves the term undefined, the United States Supreme Court enunciated a test in its *Howey* decision for determining whether a transaction is an investment contract.¹⁸ There the Court held that an investment contract is a “transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”¹⁹ In other words, an investment contract exists if there is “[1] an investment of money [2] in a common enterprise [3] with profits to come [4] solely from the efforts of others.”²⁰

In establishing this test, the Court referred to several factors to determine whether or not its definition of an investment contract is met. Those factors include: whether the offer consists solely of a sale of property or whether it consists of “an opportunity to contribute money and to share in the profits”; whether the individual investors have the equipment and experience necessary to run the operation themselves; whether the investors’ desire is to control the operation of the enterprise or whether they are attracted solely by the potential profits generated by their investment; whether the enterprise is managed and controlled by a party other than the investors; and whether there is some evidence of the shares that allows for the determination of each investor’s pro rata portion of the profits.²¹

The Court stated that if the four elements numbered above are met, then the contract can be considered a security “regardless of the legal terminology used.”²² Moreover, no actual sale need be consummated; the Securities Act prohibits both the *offer* and the sale of unregistered, non-exempt securities.²³ Simply offering, or soliciting the purchase of, the essential aspects of an investment contract is enough to create a security that is covered by the Securities Act and SEC regulation.²⁴

¹⁷ *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8 (E.D. Ky. 1985).

¹⁸ *See Howey*, 328 U.S. at 301.

¹⁹ *Id.* at 298-99.

²⁰ *Id.* at 301 (bracketed numbers added).

²¹ *Id.* at 299-300.

²² *Id.* at 300.

²³ *Id.* at 301. *See* Securities Act of 1933 § 2(3) (2006) (definition of a sale of a security); *Id.* § 5 (registration requirements of securities).

²⁴ *Howey*, 328 U.S. at 301.

3. *The Howey Test Reshaped and Interpreted*

Over time, the courts have reshaped and interpreted the four-pronged *Howey* test.²⁵ The evolution of each of those parts will be discussed below, focusing on rulings made by the United States Supreme Court, the United States Court of Appeals for the Sixth Circuit,²⁶ and the United States District Courts of Kentucky.

a. *Investment of Money*

The most significant Supreme Court case addressing the issue of whether there is an investment of money never made an official pronouncement regarding the meaning of the term.²⁷ However, the Court in *Daniel* gave a fairly clear indication of what an investment of money is.²⁸ It noted that in every case where an investment contract had been found, “the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security.”²⁹ This exchange of consideration for an interest in a security constitutes an investment of money.

The Sixth Circuit’s initial explanation of the meaning of an investment of money applied a six-factor “risk capital” test to separate an investment transaction from a mere commercial transaction.³⁰ The six factors considered by the *Union Planters* court were (1) time; (2) collateral; (3) form of the obligation; (4) circumstances of the issuance; (5) relationship between the amount borrowed and the size of the borrower’s business; and (6) intended use of the funds.³¹ The *Union Planters* application of the “risk capital” test was also followed by the United States District Court for the Eastern District of Kentucky, in a case decided later in 1981.³² In *Wallace*, the Eastern District of Kentucky applied the same six factors to its analysis to determine if there had been the presence of an investment in the case.³³

²⁵ See, e.g., *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975) (discussing the “expectation of profits” requirement).

²⁶ The circuit in which Kentucky is located, and which Kentucky federal courts must follow.

²⁷ See *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979).

²⁸ See *id.* at 560.

²⁹ *Id.*

³⁰ *Union Planters Nat’l Bank v. Commercial Credit Bus. Loan, Inc.*, 651 F.2d 1174, 1182 (6th Cir. 1981).

³¹ *Id.*

³² *Am. Bank & Trust Co. v. Wallace*, 529 F. Supp. 258, 261 (E.D. Ky. 1981).

³³ *Id.*

However, two more recent rulings suggest that the Sixth Circuit no longer adheres to the “risk capital” analysis to determine whether or not there has been an investment satisfying the first prong of *Howey*. In the first case, the Sixth Circuit took a step toward disavowing the “risk capital” test when it implied that the “risk capital” test was too expansive to fit within the *Howey* test.³⁴ Moreover, in the most recent case, the Sixth Circuit, sitting in Kentucky, found that there was an investment present in the simple situation where checks from the plaintiff investors were received and cashed by the defendant as part of the investment contract.³⁵ In reaching its conclusion, the *Stone* court completely avoided any application—indeed, any mention—of the “risk capital” test. It simply stated that an investment was found where checks intended for the investment were cashed.³⁶

The implications of this apparent Sixth Circuit trend impact the test used by the Kentucky federal courts, since the District Courts of Kentucky are bound to follow Sixth Circuit precedent. Current Sixth Circuit precedent appears to point toward not applying the “risk capital” test for purposes of determining whether an investment is present.³⁷ In fact, the most recent case to address the issue failed to even mention the “risk capital” test, implying that it was not to be used to analyze the investment issue.³⁸ The result in *Stone* (the court found an investment of money where checks from the plaintiff intended for the investment were cashed by the defendant³⁹) actually looks much more like the United States Supreme Court’s understanding of an investment of money as given in *Daniel*.⁴⁰ Thus, it appears that the Kentucky federal courts would be likely to find the first prong of *Howey* satisfied if the investor exchanges tangible consideration for an interest that can be characterized as a security.⁴¹

b. *Common Enterprise*

Despite the many years since *Howey* was decided, the United States Supreme Court has not yet provided a definition of a common enterprise to satisfy *Howey*’s second prong. However, the United States Circuit Courts of Appeals have addressed the issue, creating two separate formulations to interpret “common enterprise.”⁴² The first formulation, known as vertical commonality, finds a common enterprise where “the fortunes of the investor

³⁴ See *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 281-82 (6th Cir. 1989).

³⁵ *Stone v. Kirk*, 8 F.3d 1079, 1085 (6th Cir. 1993).

³⁶ *Id.*

³⁷ See *Stone*, 8 F.3d at 1085; *Deckebach*, 867 F.2d at 281-82.

³⁸ *Stone*, 8 F.3d at 1085.

³⁹ *Id.*

⁴⁰ See *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 559 (1979).

⁴¹ See *id.*

⁴² SODERQUIST & GABALDON, *supra* note 16, at 4.

are interwoven with and dependent upon the efforts and successes of those seeking the investment or of third parties.”⁴³ The alternative to vertical commonality, horizontal commonality, was established initially by the Seventh Circuit,⁴⁴ although the court did not use the term in its discussion. The Sixth Circuit subsequently followed the Seventh Circuit’s lead, also adopting the horizontal commonality approach to finding a common enterprise.⁴⁵

In adopting horizontal commonality as the requirement, the Sixth Circuit explained that to satisfy that requirement for the purposes of finding a common enterprise, there must be both the pooling of investor funds as well as a relationship between the investors themselves “which ties the fortunes of each investor to the success of the overall venture.”⁴⁶ In order to find this pooling of funds, the Sixth Circuit noted that it would look beyond the specific agreement each investor formed with the manager of the funds to find horizontal commonality.⁴⁷ Following Supreme Court precedent, the Sixth Circuit stated that the economic realities of the agreement—essentially the totality of the circumstances—must be considered in order to properly determine whether the horizontal commonality requirement is satisfied to find a common enterprise.⁴⁸ Perhaps the best indication of the Sixth Circuit’s interpretation of horizontal commonality is found in the *Union Planters* opinion. There, the court found horizontal commonality where the fortunes of the investors were “inextricably intertwined.”⁴⁹ According to the Sixth Circuit, all investors in a common enterprise share a common fortune.⁵⁰ Along with horizontal commonality, the Sixth Circuit has required that there

⁴³ Sec. & Exch. Comm’n v. Glenn W. Turner Enters., 474 F.2d 476, 482 n.7 (9th Cir. 1973). See also Sec. & Exch. Comm’n v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) (quoting *Glenn W. Turner*). The vertical commonality espoused by the Fifth and Ninth Circuits is considered strict vertical commonality. The Eleventh Circuit has adopted broad vertical commonality (an easier test to satisfy), which does not require that the issuer or promoter share in any risk with the investors. See Sec. & Exch. Comm’n v. ETS Payphones, Inc., 408 F.3d 727, 732 (11th Cir. 2005) (“That [broad vertical commonality] test requires the movant ‘to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns.’”) (internal citation omitted).

⁴⁴ See *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 278 (7th Cir. 1972).

⁴⁵ *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980), *aff’d*, 456 U.S. 353 (1982).

⁴⁶ *Id.* at 223-24.

⁴⁷ Sec. & Exch. Comm’n v. Prof’l Assocs., 731 F.2d 349, 354 (6th Cir. 1984).

⁴⁸ *Id.* See also *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

⁴⁹ *Union Planters Nat’l Bank of Memphis v. Commercial Credit Bus. Loan, Inc.*, 651 F.2d 1174, 1183 (6th Cir. 1981).

⁵⁰ *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 282 (6th Cir. 1989).

also be proof of a vertical relationship between the buyer and the seller of the investment interest to find a common enterprise under *Howey*.⁵¹

Despite the many Sixth Circuit opinions offering a clarification of the horizontal commonality test for a common enterprise, the Federal District Courts of Kentucky have done no interpretation of their own. One court, the District Court for the Eastern District of Kentucky, simply noted the Sixth Circuit's *Union Planters* definition of horizontal commonality.⁵² The same court, in an earlier ruling, emphasized the pooling requirement of horizontal commonality, finding that a promissory note entered into solely between a single holder and *one* issuer did not constitute a common enterprise.⁵³ However, because both of these decisions occurred in the Eastern District of Kentucky, they are not binding on the Western District of Kentucky; the Sixth Circuit decisions on the issue of what constitutes a common enterprise are binding on both districts, though. Hence, in a Kentucky federal court, a common enterprise will be found where there is both a vertical relationship between the buyer and the seller⁵⁴ as well as a horizontal relationship amongst the buyer-investors themselves.⁵⁵

c. *Expectation of Profits*

In interpreting the third prong of *Howey*, the Supreme Court has noted two alternatives for what constitutes profits: (1) the capital appreciation that results from managing and developing the original investment; and (2) a participation in earnings that are derived from the use of the investors' funds.⁵⁶ The Court's decision in *Forman* also implied what is meant by the expectation of profits. An expectation of profits exists when the investor is attracted only to the potential returns on his investment.⁵⁷ However, where the investor is interested in the investment because of his intent to "use or consume" the item purchased, there is no expectation of profits.⁵⁸ In the former case, an investment contract and, therefore, a security, would be found; in the latter case, no investment contract would exist, and so no security would be found.⁵⁹

The Sixth Circuit and the Federal District Courts of Kentucky have done very little additional interpretation of this prong of the *Howey* test. In *Union Planters*, the Sixth Circuit noted the *Howey* criteria of profits—either

⁵¹ *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989).

⁵² *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8 (E.D. Ky. 1985).

⁵³ *Am. Bank & Trust Co. v. Wallace*, 529 F. Supp. 258, 263 (E.D. Ky. 1981).

⁵⁴ *Newmyer*, 888 F.2d at 394.

⁵⁵ *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980).

⁵⁶ *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975)

⁵⁷ *Id.*

⁵⁸ *Id.* at 852-53.

⁵⁹ *See id.* at 853.

capital appreciation or earnings from the use of investor funds—but went no further.⁶⁰ The Federal District Courts of Kentucky have also failed to offer their opinion on the meaning of “expectation of profits,” instead seemingly addressing other more contentious issues.

Thus, this lack of development within the Sixth Circuit and the Federal District Courts of Kentucky suggests two things. First, the *Howey-Forman* combined understanding of profits is probably the test that will be followed by the Sixth Circuit and the Federal District Courts of Kentucky. Second, the test for the “expectation of profits” prong of *Howey* is apparently easily applied in most cases. The only instance in which a court may tend not to find an expectation of profits is in a situation in which *Forman* applies, meaning that the investment was made for the “use or consum[ption]” of the item rather than for returns generated by appreciation or management of the funds invested.⁶¹

d. *Solely from the Efforts of Others*

Though the Supreme Court in *Howey* stated that profits on the investment must be “solely from the efforts of others,”⁶² later decisions by the Court have created uncertainty as to whether “solely” should be read literally.⁶³ The Court in *Forman*, while describing the *Howey* test, explained that “the touchstone [of an investment contract] is the presence of an investment in a common venture premised on a reasonable expectation of profits *to be derived from the entrepreneurial or managerial efforts of others*.”⁶⁴ The Court clearly left “solely” out of its interpretation in *Forman*, but then also stated that it expressed no opinion as to whether “solely” should be read literally or not.⁶⁵ A later Supreme Court case, *Daniel*, also followed the investment contract definition as interpreted by *Forman*.⁶⁶ However, in both *Forman* and *Daniel*, the question of whether “solely” was to be interpreted literally was not at issue, and the *Forman* court explicitly stated as much.⁶⁷ In the only case in which the “solely” language was arguably at issue,⁶⁸ the Supreme Court left much to be desired in its conclusion. The

⁶⁰ *Union Planters Nat’l Bank v. Commercial Credit Bus. Loan, Inc.*, 651 F.2d 1174, 1184 (6th Cir. 1981).

⁶¹ *See Forman*, 421 U.S. at 852-53.

⁶² *Sec. & Exch. Comm’n v. W. J. Howey Co.*, 328 U.S. 293, 301 (1945).

⁶³ *See Forman*, 421 U.S. at 852; *Daniel*, 439 U.S. at 561; *Sec. & Exch. Comm’n v. Edwards*, 540 U.S. 389, 395 (2004).

⁶⁴ *Forman*, 421 U.S. at 852 (bracketed text and emphasis added).

⁶⁵ *Id.* at 852 n.16.

⁶⁶ *Daniel*, 439 U.S. at 561.

⁶⁷ *Forman*, 421 U.S. at 852 n.16.

⁶⁸ *Edwards*, 540 U.S. at 389.

Edwards Court did continue both the *Howey* and *Forman* formulations of an investment contract discussed previously, but it failed to describe how to interpret "solely." Without interpreting "solely," the Court simply concluded that just because investors had contracted with the seller for a fixed return, it did not mean that the return would not come solely from the efforts of the seller.⁶⁹

Because the Supreme Court has provided little assistance in interpreting the fourth prong of the *Howey* test, it is necessary to review the decisions of the Sixth Circuit and the Federal District Courts of Kentucky. First, the *Union Planters* court stated that to satisfy the fourth prong of the *Howey* test, the profits must be "derived from the managerial or entrepreneurial efforts of others."⁷⁰ Moreover, mere administrative tasks, such as supervising the investment or collecting payments do not qualify as managerial or entrepreneurial efforts for purposes of the fourth prong.⁷¹ In addition, the Sixth Circuit has provided its own understanding of how the term "solely" is to be interpreted.⁷² The court stated that "solely" is not to be read literally.⁷³ Instead, the court will consider the economic realities of the agreement.⁷⁴ As the *Odom* court noted, the problem with reading "solely" literally is that such a reading would exclude from securities laws any enterprise in which the investor took any sort of role.⁷⁵ The reason for this result is that the profits would not come only from the efforts of others.⁷⁶ This indicates that complete investor passivity is not a requirement to satisfy the fourth prong. Actually, the Sixth Circuit, following the leads of other circuits, has stated that enterprises will not be excluded from classification as investment contract securities as long as the investor's involvement does not entail a significant managerial role.⁷⁷

In fact, the distinction between passive and active investors is the area given the most attention by the Sixth Circuit in interpreting the fourth prong of *Howey*. The *Professional Associates* court found specifically that the presence of purely passive investors compelled the finding of an investment contract.⁷⁸ And the *Odom* court specifically noted that a general partnership

⁶⁹ *Id.* at 397.

⁷⁰ *Union Planters Nat'l Bank v. Commercial Credit Bus. Loan, Inc.*, 651 F.2d 1174, 1185 (6th Cir. 1981).

⁷¹ *Id.*

⁷² *Sec. & Exch. Comm'n v. Prof'l Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Odom v. Slavik*, 703 F.2d 212, 214-15 (6th Cir. 1983).

⁷⁶ *Id.* at 215.

⁷⁷ *Id.*

⁷⁸ *Prof'l Assocs.*, 731 F.2d at 357.

typically does not qualify as a security.⁷⁹ This is because a general partner usually has managerial powers that enable him to protect himself to such an extent that it takes him outside the scope of the securities acts.⁸⁰ Indeed, the Sixth Circuit has concluded that as long as the general partner has the *power to participate* in a managerial capacity, even if that power is not exercised, the partnership will not be considered a security.⁸¹

However, there may be instances where a general partnership is classified as a security. Principally, quoting the Fifth Circuit, the Sixth Circuit has determined that:

A general partnership or a joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced or unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.⁸²

Interestingly, the quote also demonstrates that where an investor's powers in the enterprise are limited by the agreement, as, for example, in a limited partnership (LP), a security may be found.⁸³ This is also the case in a manager-managed limited liability company (LLC).⁸⁴ In contrast to the LP and the manager-managed LLC, the simple selection of other types of business entities such as the member-managed LLC or the general partnership provides an additional avenue for issuers to avoid classification of their enterprise as a security.⁸⁵

⁷⁹ *Odom*, 703 F.2d at 215. This was also stated by Robert Beck, a practicing equine attorney in Kentucky. Telephone Interview with Robert Beck, Member, Stites & Harbison (Jan. 29, 2010).

⁸⁰ *Odom*, 703 F.2d at 215.

⁸¹ *Id.* at 216.

⁸² *Id.* at 215 (quoting *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981)).

⁸³ *Odom*, 703 F.2d at 215.

⁸⁴ Telephone Interview with Joshua Cooper, COO, West Point Thoroughbreds, Inc. (Jan. 28, 2010).

⁸⁵ Telephone Interview with Robert Beck, *supra* note 79; Telephone Interview with James Philpott, Of Counsel, Stoll Keenon Ogden (Jan. 26, 2010).

In the most recent Sixth Circuit case to directly address the fourth prong of *Howey*, the court enunciated several factors that are relevant in determining whether an investor's contractual powers can realistically be exercised or whether they were simply added to the investment agreement in an attempt to avoid the securities laws.⁸⁶ Citing the Eighth Circuit, the first three factors are: (1) the investor's lack of business knowledge; (2) his lack of finances; and (3) his lack of control over the operations.⁸⁷ The Sixth Circuit also added three other additional factors to the list, including: (4) the nature of the product sold; (5) the character of the selling firm; and (6) the nature of the industry in which the investment is involved.⁸⁸

The Federal District Courts of Kentucky have also offered some guidance on the interpretation of the fourth prong of *Howey*. Notably, the Eastern District of Kentucky recognized the Fifth Circuit's interpretation of the fourth prong, which read "solely from the efforts of others" to really be a question of whether the efforts made by the manager of the investment were the "undeniably significant ones."⁸⁹ Two other cases, however, both in the Eastern District of Kentucky, decided not to use the "undeniably significant" language recognized by *Smith*.⁹⁰ Instead, both opinions understood the fourth prong of *Howey* in the same way as the Sixth Circuit's interpretation did in *Union Planters*.⁹¹ Both concluded that to satisfy the fourth prong, the profits of the enterprise must be derived from the entrepreneurial or managerial efforts of those other than the investors.⁹² However, the "undeniably significant" language was later used by the Sixth Circuit to provide further interpretation of the fourth prong.⁹³ Because the "undeniably significant" language was set forth in its most recent case to directly address the fourth prong, it is likely the Sixth Circuit's preferred construction of the "solely from the efforts of others" language of *Howey*. This makes that approach binding on the Federal District Courts of Kentucky as well.

⁸⁶ *McCoy v. Hilliard*, 940 F.2d 660 (Table), 1991 WL 132522, at *8 (6th Cir. 1991).

⁸⁷ *Id.* (citing *Schultz v. Dain Corp.*, 568 F.2d 612, 615 (8th Cir. 1978) and *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 915 (8th Cir. 1976)).

⁸⁸ *McCoy*, 1991 WL 132522, at *8.

⁸⁹ *Smith v. Manausa*, 385 F. Supp. 443, 448 (E.D. Ky. 1974) (quoting *Glenn W. Turner*, 474 F.2d at 482).

⁹⁰ See *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8 (E.D. Ky. 1985); *Am. Bank & Trust Co. v. Wallace*, 529 F. Supp. 258, 263 (E.D. Ky. 1981).

⁹¹ See *Union Planters Nat'l Bank v. Commercial Credit Bus. Loan, Inc.*, 651 F.2d 1174, 1185 (6th Cir. 1981).

⁹² *Kefalas*, 630 F. Supp. at 8; *Wallace*, 529 F. Supp. at 263.

⁹³ *McCoy*, 1991 WL 132522, at *8.

B. *Kentucky Securities Laws and the Kentucky Test for Investment Contracts*

The efforts to avoid securities laws issues in the Thoroughbred industry—by either showing that shares of a Thoroughbred are not securities or by exempting the shares from registration if they are securities—do not pertain only to the federal laws; states, too, have their own securities laws. In fact, before Congress had even passed the Securities Act of 1933, most states had already been involved in regulating securities for many years.⁹⁴ Compared to the Securities Act, most state securities law schemes involve a similar process of regulation.⁹⁵ The securities must typically be registered before sale, unless the registration is preempted by federal law or there is an exemption available under which the securities are covered.⁹⁶

Because state laws are also critically important to the securities laws issues surrounding shares of Thoroughbreds, the following subsections address the Commonwealth of Kentucky's approach to the regulation of securities under its state blue sky laws. Fortunately, the process for examining the Kentucky securities laws below is virtually identical to that followed above to describe the federal securities laws. Section II-B-1 below discusses the Kentucky definition of a security as well as provides a summation of the Kentucky registration requirements. Section II-B-2 explains how the Courts of the Commonwealth of Kentucky understand the term "investment contract." As will become evident, the Kentucky definition of a security and the Kentucky state courts' definition of an investment contract are incredibly similar to their federal counterparts.

1. *The Kentucky Blue Sky Laws: Definitions and Registration Requirements*

a. *Section 292.310(18): The Definition of a Security*

Just as with the process of analyzing the applicability of securities laws in the federal law context, the first step in determining whether state securities laws apply to shares of syndicated Thoroughbreds is to know how the Kentucky General Assembly has defined the term "security" and how the Kentucky Department of Financial Institutions' Division of Securities understands the term. Section 292.310(18) of the Kentucky Blue Sky Laws

⁹⁴ SODERQUIST & GABALDON, *supra* note 16, at 19.

⁹⁵ *Id.* at 20.

⁹⁶ *Id.*

contains the specific definition of a security.⁹⁷ Like the Securities Act definition at the federal level, the Kentucky Blue Sky Laws definition of “security” begins with those things most commonly thought of as securities, particularly notes, stocks, bonds, and debentures.⁹⁸ The Kentucky definition also includes such things as fractional interests in mineral rights.⁹⁹ Finally, and most importantly, as with the Securities Act definition, the Kentucky Blue Sky Laws definition contains within it the investment contract.¹⁰⁰

As Congress failed to do in the Securities Act of 1933, the Kentucky General Assembly has also not defined the term “investment contract” in its Blue Sky Laws. However, the Courts of Kentucky have come to the rescue, enunciating their definition of an investment contract, as will be explained in Section II-B-2. This point is important because, as noted previously, if a share of a Thoroughbred is to be considered a security, it would have to be so as an investment contract.¹⁰¹ Moreover, if a share of a syndicated Thoroughbred is found to be a security, it will be subject to the Kentucky Blue Sky Laws’ registration requirements unless it is granted a state exemption.¹⁰²

b. Sections 292.340 – 292.370: Registration Requirements

Section 292.340 of the Kentucky Blue Sky Laws establishes the general registration requirements to offer to sell securities in the state. Specifically, it is unlawful to sell or offer to sell any unregistered securities within Kentucky, with certain exceptions.¹⁰³ Those exceptions are if the security or the transaction is exempt under chapter 292 or if the security is a covered security.¹⁰⁴ Pursuant to the Blue Sky Laws, there are three different ways securities may be registered in Kentucky. They are as follows, but, for the purposes of this paper, they will be given no more than cursory review.

The first method of registering a security in Kentucky, codified in section 292.350, is through notification.¹⁰⁵ The availability of registration by notification is based largely on past issuer action and performance with respect to securities, as well as certain issuer earnings thresholds.¹⁰⁶ The second means of registering a security in compliance with Kentucky Blue Sky Laws

⁹⁷ KY. REV. STAT. ANN. § 292.310(18) (West 2009). See generally KY. REV. STAT. ANN. ch. 292 (West 2009) [hereinafter Blue Sky Laws].

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Kefalas v. Bonnie Brae Farms, Inc., 630 F. Supp. 6, 8 (E.D. Ky. 1985).

¹⁰² SODERQUIST & GABALDON, *supra* note 16, at 20.

¹⁰³ Blue Sky Laws § 292.340 (West 2009).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* § 292.350.

¹⁰⁶ See *id.* § 292.350(1)(a)-(b).

is registration by coordination as provided in section 292.360.¹⁰⁷ This section makes eligible for registration by coordination those securities for which a registration statement has been filed with the SEC under the Securities Act of 1933 or an offering statement has been filed with the SEC under Regulation A of the Securities Act of 1933.¹⁰⁸ For registration by coordination, the registration statement becomes automatically effective at the moment the federal registration statement becomes effective,¹⁰⁹ provided certain other criteria is satisfied.¹¹⁰ The third method of registering a security pursuant to Kentucky Blue Sky Laws is registration by qualification, provided for in section 292.370.¹¹¹ This method is available to register any security,¹¹² but there is a very extensive list of requirements that the registration statement must contain in order to register by qualification.¹¹³ Most notably, compared to registration by notification or coordination, registration by qualification requires a great deal more disclosure of certain financial statements, with the amount of disclosure increasing as the amount of proceeds from the offering increases.¹¹⁴

2. *The Kentucky Test for Investment Contracts*

a. *Investment Contracts as Defined by the Kentucky Courts*

In order for a share of a syndicated Thoroughbred to be considered a security for purposes of the Kentucky Blue Sky Laws, it will likely have to fall under the auspices of an investment contract,¹¹⁵ just as was the case under the Securities Act on the federal level. However, because the Kentucky General Assembly has left the term “investment contract” undefined in its statutes, it is necessary to review the cases decided by the Kentucky state courts.

Surprisingly, even with the level of sophistication contained in the Blue Sky Laws, there have only been two Kentucky cases that have directly addressed the issue of defining “investment contract” as it applies to state securities laws. First, in 1974, the Kentucky Court of Appeals, then the highest court in the Commonwealth,¹¹⁶ made its ruling on the issue.¹¹⁷ The

¹⁰⁷ *Id.* § 292.360.

¹⁰⁸ *Id.* § 292.360(1).

¹⁰⁹ *Id.* § 292.360(3).

¹¹⁰ *Id.*

¹¹¹ *Id.* § 292.370.

¹¹² *Id.* § 292.370(1).

¹¹³ *See id.* § 292.370(2).

¹¹⁴ *See id.* § 292.370(2)(p).

¹¹⁵ *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8 (E.D. Ky. 1985).

¹¹⁶ *Id.* at 9.

¹¹⁷ *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138, 141, 142 (Ky. 1974).

Waddle court adopted as the rule for Kentucky the definition for an investment contract as set forth by the United States Supreme Court in *Howey*.¹¹⁸ The *Waddle* court stated that the test for an investment contract was “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”¹¹⁹ However, the court also recognized that the use of the term “solely” as set forth in the *Howey* test was too restrictive.¹²⁰ As a result, the court adopted the Ninth Circuit’s language to resolve the issue, stating that “solely” should be not be read strictly or literally and instead should be interpreted realistically to include those enterprises that are securities in substance.¹²¹ Principally, the *Waddle* court found an investment contract where the investors themselves had to exert some effort to generate the profits, even though the profits were not “solely” the result of others’ efforts.¹²²

The second and more recent case to interpret “investment contract” was decided in late 2007.¹²³ Citing *Waddle*, the *Greenleaf* court noted Kentucky’s adoption of the *Howey* test.¹²⁴ However, in enunciating its understanding of the test, the court also rewrote the test to consider the *Waddle* court’s decision not to read “solely” literally.¹²⁵ The test, as stated in *Greenleaf*, interpreted *Waddle* to find an investment contract where there is “1) the presence of an investment; 2) in a common scheme or enterprise; 3) premised on a reasonable expectation of profits; 4) to be derived from the entrepreneurial or managerial efforts of others.”¹²⁶ Several things are notable about this test. Clearly, the first three prongs square with *Howey*. The fourth prong is different from that of *Howey* though. In fact, the “entrepreneurial or managerial efforts of others” language is exactly comparable to the language in the United States Supreme Court’s decision in *Forman*.¹²⁷

The Court of Appeals in *Greenleaf* also clarified another aspect of the Kentucky interpretation of “investment contract” as it pertains to the Kentucky Blue Sky Laws. Without using the exact terminology, the *Greenleaf* court recognized that the common enterprise requirement was subject to horizontal

¹¹⁸ *Id.* at 141.

¹¹⁹ *Id.* (quoting *Sec. & Exch. Comm’n v. W. J. Howey Co.*, 328 U.S. 293, 301 (1945)).

¹²⁰ *Waddle*, 507 S.W.2d at 142.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Commonwealth ex rel. Comm’r of Dep’t of Fin. Insts. of Commonwealth v. Greenleaf Mktg. Corp.*, No. 2006-CA-001934-MR, 2007 WL 3406766 (Ky. Ct. App. Nov. 16, 2007).

¹²⁴ *Id.* at *1.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Compare Greenleaf*, 2007 WL 3406766, at *1 with *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975).

commonality.¹²⁸ The court suggested that to find a common enterprise, the investors must pool their money and they much each share in the overall success and failure of the enterprise.¹²⁹

Thus, it appears that the test for an investment contract in Kentucky is the *Howey* test with a flexible reading of the term “solely.” This is at least how the *Greenleaf* court understood *Waddle*.¹³⁰ Considering *Waddle*’s mandate for flexible interpretation of “solely,” it is unlikely that the Kentucky Supreme Court will reject the *Greenleaf* understanding of an investment contract. The result, therefore, is that the lower courts in Kentucky will likely apply the *Greenleaf* test unless and until the Kentucky Supreme Court decides a change is necessary. Overall, then, Kentucky’s definition of an investment contract as it applies to the Kentucky Blue Sky Laws is largely identical to the United States’ definition of an investment contract as it applies to the Securities Act of 1933.¹³¹

b. *The Kentucky Securities Regulations: 10:360¹³² and
Investment Contracts*

While the investment contract analysis is a court-determined test, there is an interesting qualification to the definition of investment contracts provided for in section 10:360 of the Kentucky Securities Regulations. This section acts as a safe harbor for membership interests in *member-managed* LLCs, establishing that those interests are not considered investment contracts.¹³³ However, certain criteria must be met to fall within the safe harbor. First, the aggregate number of membership interests after all interests are sold must not exceed thirty-five.¹³⁴ In addition to this requirement, at least one of the following three points must also be satisfied: (1) Each member is actively engaged in the management of the LLC¹³⁵; (2) The articles of organization vest management power of the LLC in a manager who is a member and also provide that a simple majority vote of the members may

¹²⁸ *Greenleaf*, 2007 WL 3406766, at *2.

¹²⁹ *Id.*

¹³⁰ *Id.* at *1. Note that the *Greenleaf* court never mentioned *Forman* in its opinion. Instead, it attributed the “investment contract” test, including the “entrepreneurial and managerial efforts of others” language to the *Waddle* court. This *Forman* language is presumed by the author to be the method chosen by the Court of Appeals to address *Waddle*’s mandate for Kentucky courts not to read “solely” literally.

¹³¹ See *supra* note 127 for a comparison of the federal and Kentucky tests.

¹³² 808 KY. ADMIN. REGS. 10:360 (2006).

¹³³ *Id.* § 1.

¹³⁴ *Id.*

¹³⁵ *Id.* § 1(1).

replace the manager with any other member¹³⁶; or (3) Under either the applicable law or the articles of organization, each member has the power to act for or bind the LLC.¹³⁷

Thus, the satisfaction of the above criteria means that interests in a member-managed LLC are not considered securities under Kentucky state securities laws. This regulation, however, is only applicable to *member-managed* LLCs and does not pertain to manager-managed LLCs, general partnerships, or LPs. Furthermore, because there is no analogous federal regulation, membership interests in member-managed LLCs would still be subject to the *Howey-Forman* analysis to determine their status as securities under the Securities Act. In practice, though, a member-managed LLC operating pursuant to section 10:360 will also likely fail to satisfy the fourth prong of *Howey-Forman*, and so interests in that member-managed LLC will presumably not be classified as securities under federal law.¹³⁸

C. *Whether a Share of a Thoroughbred is a Security: Breeding and Racing Contexts*

Since the federal and Kentucky definitions of an investment contract have both been discussed, it is necessary to complete the first step of this paper's analysis by applying these definitions to the shares of syndicated Thoroughbreds to determine whether those shares are in fact securities. The federal and Kentucky investment contract definitions will first be applied to shares of syndicated Thoroughbreds in the breeding context, and will then be applied in the racing context.

1. *The Breeding Context*

a. *Syndicating a Thoroughbred Stallion for Breeding*

Before applying the securities laws, it is imperative to understand exactly what syndication is. The process of syndicating a Thoroughbred for breeding involves selling fractional interests (shares) in the stallion.¹³⁹

¹³⁶ *Id.* § 1(2).

¹³⁷ *Id.* § 1(3).

¹³⁸ See *supra* pp. 217-20 for the discussion of the fourth prong of *Howey-Forman*. For purposes of both federal and Kentucky securities laws, satisfaction of the fourth prong requires that profits come largely from the efforts of others. *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975); *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138, 141, 141 (Ky. 1974). Because of the active involvement of members or their power to remove the manager, member-managed LLCs fall short of satisfying this fourth prong.

¹³⁹ Timothy Nicolas Sweeney, Comment, *Kefalas v. Bonnie Brae Farms: A Practical Approach to Thoroughbred Breeding Syndications and Securities Law*, 75 KY. L.J. 419, 422 (1987).

Usually, each stallion syndication will consist of fifty shares, on average.¹⁴⁰ Typically, the share includes the right to breed a mare to the stallion each year.¹⁴¹ This right, called a “season” or a “nomination,” can be sold each year.¹⁴² Moreover, the farm retains exclusive control over the breeding career of the stallion, including the right to refuse mares, sometimes even those mares proposed by syndicate owners.¹⁴³

The reasons for syndicating a Thoroughbred stallion are two-fold. First, the farm, which usually buys the stallion privately before syndication, uses syndication to spread risk.¹⁴⁴ Ideally, the farm would retain one hundred percent ownership of the stallions it buys to breed.¹⁴⁵ This is not feasible, however, because of the significant amount of money required to purchase a stallion prospect, as well as the fact that the farm would carry all the risk of the stallion prospect’s success or failure at stud.¹⁴⁶ So the farm instead syndicates the stallion, sells some of the shares, and maintains some level of ownership, usually around fifty percent.¹⁴⁷ However, a farm may choose to own more or less than fifty percent depending on its financial needs.¹⁴⁸ Regardless of what percentage ownership is retained, selling off some amount results in a shift of some risk to the share purchasers.¹⁴⁹

The second reason for syndicating a stallion is to provide the farm with some certainty regarding breeding.¹⁵⁰ Because the share usually includes the right to breed a mare to the stallion each year, the farm assures itself of at least some breeding prospects for the stallion.¹⁵¹ Since the farm retains the shares that are not sold, it also can either breed its own broodmares to its stallions or it can sell seasons to non-shareholding breeders.¹⁵² The sale of seasons to non-shareholding breeders is what generates additional substantial revenues, and potentially profits, for the farm.

b. Is a Share of a Breeding Thoroughbred a Security?

¹⁴⁰ Telephone Interview with Doug Cauthen, President & CEO, WinStar Farm LLC (Jan. 26, 2010).

¹⁴¹ Sweeney, *supra* note 139, at 422.

¹⁴² *Id.*

¹⁴³ Telephone Interview with Doug Cauthen, *supra* note 140.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

Now that syndication for breeding purposes has been described, the more important step of applying securities laws to syndicated shares of Thoroughbred stallions can be undertaken. Obtaining the answer to whether a share of a breeding Thoroughbred constitutes a security would ordinarily be difficult because one must consider both federal and state securities laws. Fortunately, there are two significant sources of guidance with regard to syndicating Thoroughbreds for breeding.

The first source is a no-action letter issued by the SEC that describes the SEC's position with regard to whether shares of Thoroughbreds for breeding can be considered securities.¹⁵³ This letter, known to those involved in Thoroughbred syndicates as the Gainesway No-Action Letter, provides a list of ten criteria which, if satisfied, cause the syndication interests to fall outside the scope of the federal (and, in practice, the state) securities laws.¹⁵⁴

The list of criteria is as follows: (1) The interests in the stallion must be sold only to breeders for use in their business; (2) Each shareholder-breeder must have complete title and control with respect to any offspring his mare produces; (3) There is to be no pooling of income or sharing in any gain or loss; (4) The owner is to retain any unpurchased shares; (5) The maintenance costs are to be divided pro rata according to the number of nominations each breeder can use; (6) The compensation of the syndicate manager must be disclosed; (7) There must be a provision addressing the issue of excess nominations, if any; (8) Each shareholder will have an insurable fractional interest in the stallion; (9) There must be a provision addressing the right of the breeders to sell their respective shares; and (10) The shareowner-breeder may sell any unused nomination to another breeder.¹⁵⁵

A principal reason why the SEC chose to take no action against John Gaines for syndicating stallions without registering the shares is based on the *Forman* test.¹⁵⁶ Recall that the *Forman* Court stated that when an investor is motivated by his desire to use or consume the item purchased, there is no expectation of profits.¹⁵⁷ And where there is no expectation of profits, the *Howey-Forman* test is not satisfied, so the investment does not constitute a security.

To satisfy the first criterion of the Gainesway No-Action Letter, the shares must essentially be sold to those who intend to use or consume them for breeding purposes.¹⁵⁸ Moreover, the third criterion touches upon the *Howey-*

¹⁵³ John R. Gaines and Gainesway Farm, Inc., SEC No-Action Letter, 1977 WL 10973 (July 18, 1977).

¹⁵⁴ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with James Philpott, *supra* note 85.

¹⁵⁵ Gainesway, *supra* note 153, at *3.

¹⁵⁶ *Id.*

¹⁵⁷ *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975).

¹⁵⁸ Gainesway, *supra* note 153, at *3

Forman test as well as the horizontal commonality requirements established in both the federal and state courts of Kentucky.¹⁵⁹ As it says, there is to be no pooling of funds and sharing in gains or losses.¹⁶⁰ This defeats horizontal commonality, and causes the failure to trigger the “common enterprise” prong of *Howey*.¹⁶¹ Finally, several of the criteria working together, especially the ninth and tenth criteria ensure active participation and involvement on the part of the breeder-shareowners. This results again in the failure to satisfy the fourth prong of *Howey-Forman*, which requires that any returns be generated by the managerial efforts of others.¹⁶² It is clearly evident that following these ten criteria accepted by the SEC results in the finding that syndicated shares of Thoroughbreds for breeding are not investment contracts because three of the four prongs of the *Howey-Forman* test go unsatisfied.

The Gainesway No-Action Letter is not the only source of guidance on the issue of whether shares of Thoroughbreds used for breeding can be considered securities, however. In fact, the United States District Court for the Eastern District of Kentucky decided a case dealing with this exact issue.¹⁶³ Though it was a federal court case, the *Kefalas* court addressed both federal and state securities law issues and concluded that under the specific facts of the case, the claims for the presence of an investment contract failed to meet both the federal and Kentucky tests.¹⁶⁴

In the case, the court found three important aspects: (1) the syndication agreement showed that it was designed to allow the purchaser to use or consume the investment¹⁶⁵; (2) applying horizontal commonality, the fractional interests were unitary in nature and each would succeed or fail regardless of how the other interests performed¹⁶⁶; and (3) the profits to be derived from the plaintiff-shareowner’s selling of their nomination rights were to be the result of the plaintiff-shareowner’s own efforts.¹⁶⁷

The first point above shows that where the syndication is designed for the interest to be used rather than to produce profits for investors, the “expectation of profits” prong of *Howey* is not met. The second point

¹⁵⁹ See *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980); *Commonwealth ex rel. Comm’r of Dep’t of Fin. Insts. of Commonwealth v. Greenleaf Mktg. Corp.*, No. 2006-CA-001934-MR, 2007 WL 3406766, at *2 (Ky. Ct. App. Nov. 16, 2007).

¹⁶⁰ *Gainesway*, *supra* note 153, at *3.

¹⁶¹ See *Sec. & Exch. Comm’n v. W. J. Howey Co.*, 328 U.S. 293, 301 (1945).

¹⁶² See *Forman*, 421 U.S. at 852.

¹⁶³ *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 6 (E.D. Ky. 1985).

¹⁶⁴ *Id.* at 8-9.

¹⁶⁵ *Id.* at 8.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

demonstrates that the “common enterprise” prong of *Howey* is also not met given that there is no horizontal commonality. The third point defeats another prong of *Howey-Forman*, namely, that the profits be derived from the managerial efforts of others. The result is that the investments at issue in *Kefalas* were found not to be securities.¹⁶⁸ The outcome was the same for both federal and state securities law requirements because of Kentucky’s adoption of the *Howey-Forman* test.¹⁶⁹

Importantly, the *Kefalas* court limited its holding to the facts of the case, noting that variations in the terms of the agreement may result in the finding of an investment contract.¹⁷⁰ In *Kefalas*, the apparent terms of the agreement seemed to satisfy the criteria set forth in the Gainesway No-Action Letter.¹⁷¹ However, as both the court in *Kefalas* and the SEC in its Gainesway No-Action Letter intimated, changing some of the many possible variables—for example, having the syndicate manager guarantee to sell the shareowner’s nomination on his behalf—could result in the finding of a security.¹⁷²

2. The Racing Context

a. Syndicating a Thoroughbred for Racing

The process of syndicating a Thoroughbred for racing purposes is quite similar to doing so for breeding purposes. Essentially, it still involves selling ownership interests that are considered undivided fractional interests.¹⁷³ With racing syndicates, investors can usually buy two-and-a-half, five, or ten percent interest in a horse.¹⁷⁴ Those investors are also made aware that they should not expect to make any profits on the investment because of the high-risk nature of the sport; instead, the shares are bought for their entertainment value.¹⁷⁵ Any unsold percentage of each syndicated racehorse remains owned by the syndicate.¹⁷⁶ Costs are distributed pro rata to each investor, and profits, if there are any, are distributed in the same manner.¹⁷⁷

¹⁶⁸ *Id.* at 8-9.

¹⁶⁹ *Id.* at 9 (citing *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138, 141 (Ky. 1974)).

¹⁷⁰ *Kefalas*, 630 F. Supp. at 7-8.

¹⁷¹ *See id.* at 7. The court seemingly precisely hits each of the Gainesway No-Action Letter criteria.

¹⁷² *See id.* at 7-8; Gainesway, *supra* note 153, at *4.

¹⁷³ Telephone Interview with Robert Beck, *supra* note 79.

¹⁷⁴ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, CEO, Team Valor International (Jan. 21, 2010).

¹⁷⁵ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174.

¹⁷⁶ Telephone Interview with Joshua Cooper, *supra* note 84.

¹⁷⁷ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174.

More importantly, the syndicate retains entire control over the racing career of the syndicated horse.¹⁷⁸

One of the interesting aspects of syndicating racehorses is how the actual racing syndication is formed. Typically, racing syndicates carry out the syndication by placing each horse in ownership under a separate business entity.¹⁷⁹ For example, it is common to set up each horse syndicate as a general partnership, a member-managed LLC, or a manager-managed LLC.¹⁸⁰ Doing so, however, raises certain securities law issues that must be addressed in order to ensure there is no violation of federal or state securities laws.

b. Is the Share of a Racing Thoroughbred a Security?

In asking whether the shares of Thoroughbred syndicated for racing purposes are considered securities, one place to start is with the business entity form chosen to “own” the horse. For example, establishing a syndicate by means of a general partnership or member-managed LLC is probably the easiest way to avoid the registration requirements of federal and Kentucky securities laws.¹⁸¹ This is because general partners and members of a member-managed LLC have the power to participate in management, and as long as they have that power, their enterprise will not be considered a security.¹⁸² Furthermore, the Kentucky regulations explicitly provide that, for purposes of the Kentucky Blue Sky Laws, membership interests in *member-managed* LLCs are not investment contracts, and so are not securities.¹⁸³ Even though they may be considered securities under federal law, the reality is that those membership shares are also unlikely to be securities under federal law.¹⁸⁴

¹⁷⁸ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174.

¹⁷⁹ Telephone Interview with Robert Beck, *supra* note 79; Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174.

¹⁸⁰ Telephone Interview with Robert Beck, *supra* note 79; Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174. See also Dogwood Stables, Anatomy of a Partnership, <http://www.dogwoodstable.com/anatomy-of-a-partnership.shtml> (last visited Feb. 1, 2010).

¹⁸¹ Telephone Interview with Robert Beck, *supra* note 79; Telephone Interview with James Philpott, *supra* note 85.

¹⁸² Odom v. Slavik, 703 F.2d 212, 216 (6th Cir. 1983). The same conclusion was stated by Robert Beck in his interview. Telephone Interview with Robert Beck, *supra* note 79.

¹⁸³ 808 KY. ADMIN. REGS. 10:360 § 1 (2006).

¹⁸⁴ Telephone Interview with Robert Beck, *supra* note 79.

However, securities problems may arise even in the case of a general partnership or a member-managed LLC if the agreement really distributes power in a manner similar to a limited partnership; or if the investors are so inexperienced or unknowledgeable that they are incapable of intelligently exercising their powers; or if the investors so rely on the managerial efforts of the manager that the investors cannot reasonably exercise their partnership powers.¹⁸⁵ The same problems also apply in the context of a manager-managed LLC, in which the non-managing members do not play an active role in the management of the syndication.¹⁸⁶ The inability of partners or members to participate in management results in the satisfaction of the fourth *Howey-Forman* prong because any returns generated on the investment are largely the results of the efforts of others.¹⁸⁷ However, this may be defeated by giving member-shareowners votes regarding large capital expenditures for the horse as well as decisions to dissolve the syndicate entity upon culmination of the horse's racing career.¹⁸⁸ It may also be defeated by giving members the power to remove the managing member or managing partner.¹⁸⁹

Furthermore, like the case of syndicating Thoroughbred stallions for breeding, there is another SEC no-action letter, the Star Recruit No-Action Letter, that suggests that shares of Thoroughbreds syndicated for racing may constitute securities.¹⁹⁰ The difference between the Star Recruit No-Action Letter and the Gainesway No-Action Letter lies in the fact that the syndication of the racehorse Star Recruit was to involve a syndication of the horse (without the use of a corporate entity) during his racing career, with each shareholder also receiving breeding rights for Star Recruit's stud career.¹⁹¹

The details of the Star Recruit syndication agreement contain several provisions that would appear to satisfy the *Howey* test. First, all decisions regarding the management of the horse's racing career were to be made by the racing manager.¹⁹² This is strong indication of the presence of the fourth prong of *Howey*, that the profits be derived from the efforts of those other than the investors.¹⁹³ Second, the prior racing success of Star Recruit as well as the intent to distribute profits pro rata indicates that an expectation of profits is

¹⁸⁵ See *Odom*, 703 F.2d at 215.

¹⁸⁶ Telephone Interview with Joshua Cooper, *supra* note 84. West Point Thoroughbreds establishes their syndicates as manager-managed LLCs, but also relies on the Rule 506 exemption discussed below.

¹⁸⁷ Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293, 301 (1945).

¹⁸⁸ Telephone Interview with Barry Irwin, *supra* note 174.

¹⁸⁹ Telephone Interview with Robert Beck, *supra* note 79. See also 808 KY. ADMIN. REGS. 10:360 § 1(2) (2006).

¹⁹⁰ Syndication of Star Recruit, SEC No-Action Letter, 1993 WL 524353 (Nov. 18, 1993).

¹⁹¹ *Id.* at *2.

¹⁹² *Id.*

¹⁹³ See Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293, 301 (1945).

warranted,¹⁹⁴ thus meeting the third prong of *Howey*.¹⁹⁵ Third, the investors were to share pro rata in the profits and losses of the syndicate during the horse's racing career.¹⁹⁶ This seems to indicate the satisfaction of *Howey*'s common enterprise requirement,¹⁹⁷ and actually probably meets the Kentucky horizontal commonality test for a common enterprise.¹⁹⁸ The investors all share in the success or failure of the enterprise here because it is impossible that one investor would realize a profit by owning a share of Star Recruit while another would suffer a loss. Fourth, the investment of money in exchange for the fractional interest in Star Recruit clearly satisfied the *Howey* test's first requirement of an investment of money.¹⁹⁹

Thus, in the case of a racehorse syndicated during its racing career, it would appear that the SEC's determination that it could not refuse to take action in the syndication of Star Recruit strongly indicates that shares of Thoroughbreds for racing can be found to be investment contracts. Indeed, to approach the situation with any different attitude would be imprudent.²⁰⁰ Moreover, because Kentucky adopted the *Howey-Forman* test in *Waddle and Greenleaf*, the conclusion is the same for both federal and Kentucky securities laws.

However, as the discussion above suggests, syndicating a Thoroughbred in the racing context through entities such as general partnerships, member-managed LLCs, or manager-managed LLCs may be enough to avoid having those interests classified as securities. This hinges on the extent to which members or partners can actively participate in management. If there are no active management opportunities for the members or partners, it is likely that the shares will be considered investment contract securities.²⁰¹ Part of the problem with any of these entity forms, though, is that the original issuer of the shares typically maintains full decisionmaking power with respect to the horse's racing career,²⁰² giving

¹⁹⁴ Star Recruit, *supra* note 190, at *1, *2.

¹⁹⁵ See *Howey*, 328 U.S. at 301.

¹⁹⁶ Star Recruit, *supra* note 190, at *2.

¹⁹⁷ See *Howey*, 328 U.S. at 301.

¹⁹⁸ See *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980); *Commonwealth ex rel. Comm'r of Dep't of Fin. Insts. of Commonwealth v. Greenleaf Mktg. Corp.*, No. 2006-CA-001934-MR, 2007 WL 3406766, at *2 (Ky. Ct. App. Nov. 16, 2007).

¹⁹⁹ See *Howey*, 328 U.S. at 301.

²⁰⁰ Telephone Interview with Joshua Cooper, *supra* note 84.

²⁰¹ See 808 KY. ADMIN. REGS. 10:360 § 1 (2006); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983).

Telephone Interview with Robert Beck, *supra* note 79.

²⁰² Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174.

other members or partners little ability to determine when and where the horse races. This may be enough to cause the interests in these entity forms to satisfy the fourth prong of *Howey-Forman*, thus classifying them as securities—assuming the other three prongs are met.

Even though syndicating a Thoroughbred racehorse through entity forms such as general partnerships, member-managed LCCs, and manager-managed LLCs can rebut the classification of those interests as securities, the issue is still somewhat tenuous because it depends on the extent of the manager's control. Thus, the safe way to proceed is to seriously consider the possibility that the shares or interests of Thoroughbreds syndicated for racing could be considered securities even if those shares are sold as interests in general partnerships or LLCs.

III. ARE SHARES OF SYNDICATED THOROUGHBREDS EXEMPT FROM REGISTRATION?: FEDERAL AND KENTUCKY EXEMPTIONS APPLIED TO SYNDICATED THOROUGHBREDS

The second step in the application of federal and Kentucky securities laws to the shares of syndicated Thoroughbreds is to understand how those shares may be exempted from the federal and Kentucky securities registration requirements, assuming the shares are found to be securities. Section III-A first explains the relevant federal securities laws exemptions, as set forth in both the Securities Act of 1933 as well as the SEC regulations. Section III-B performs the analogous discussion for the Kentucky exemptions laid out in the Kentucky Blue Sky Laws and the Kentucky Securities Regulations. Finally, Section III-C completes the process by applying those exemptions to shares of syndicated Thoroughbreds, again in both the breeding and racing contexts.

A. *Federal Exemptions from the Registration of Securities*

As the Supreme Court explicitly stated when reviewing the issue in *Howey*, the question of whether an investment can be considered an investment contract and thus a security is only the first question to be answered.²⁰³ If indeed a security is found, then the security is subject to the Securities Act registration requirements found in section 5(a) unless the security is covered by an exemption from those requirements.²⁰⁴

Despite the strict registration requirements placed upon securities under the Securities Act, sections 3 and 4 of the Act, as well as SEC rules, provide several methods issuers may use to exempt securities from federal registration requirements. Section III-A-1 describes the exemptions provided

²⁰³ *Howey*, 328 U.S. at 297.

²⁰⁴ *Id.*

for in the Securities Act, and Section III-A-2 explains those exemptions that have been created by the SEC in its rules.

1. *The Securities Act of 1933*

a. *Section 3(a)(11)*

Known as the Intrastate Offering exemption, section 3(a)(11) of the Securities Act exempts from federal securities laws any security offered and sold only to persons who reside within a single state or territory.²⁰⁵ However, the issuer of the security must also be a person who resides and does business within that state or territory.²⁰⁶ If the issuer is a corporation, that corporation must be incorporated by and conducting business within that state or territory.²⁰⁷

To aid issuers, the SEC has adopted Rule 147 to articulate its interpretation of section 3(a)(11). The rule explains how residence is determined for offerees and purchasers under the Intrastate Offering exemption. A corporation, partnership, trust, or other business organization is a resident if it has its principal place of business in the state or territory of the issuance at the time of the offer and sale.²⁰⁸ However, if such organization is established for the specific purpose of purchasing part of an issue offered under Rule 147, that organization is not considered a resident unless all beneficial owners of the organization are also residents of the state or territory of the issuance.²⁰⁹ An individual is a resident if, at the time of offer and sale, the individual has his principal residence in the state or territory of the issuance.²¹⁰

Though these clarifications may not be necessary to understand the Intrastate Offering exemption, they are certainly helpful because the notion of an intrastate offering rests on the common residency of the issuer and the offerees or purchasers. Without that commonality, this exemption fails to be useful for those hoping to issue securities in a single state or territory without triggering federal securities oversight.

b. *Section 3(b)*

²⁰⁵ Securities Act of 1933 § 3(a)(11) (2006).

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ 17 C.F.R. § 230.147(d)(1) (2007).

²⁰⁹ *Id.* § 230.147(d)(3).

²¹⁰ *Id.* § 230.147(d)(2).

This section of the Securities Act provides the SEC with the discretion to use its rules and regulations to “add any class of securities to the securities exempted” if enforcing the Securities Act with respect to the securities at issue is not necessary considering public interest and the protection of investors.²¹¹ However, the only instances where the SEC can deem this to be true relate to securities issuances where a small amount of money is involved or where the public offering is limited; otherwise, the SEC may not use its discretion to exempt the securities.²¹² Regarding the term “small amount,” section 3(b) specifically requires that the security issuance be of an aggregate amount less than or equal to \$5,000,000 in order to satisfy its exemption.²¹³

c. *Section 4(2)*

This section, the Private Offering exemption, is deceptively simple in its language. A security is exempt from the Securities Act registration requirements under section 4(2) if it is issued in a transaction “not involving any public offering.”²¹⁴ Logically then, a private offering is exempt. The problem is that the Securities Act of 1933 leaves “public offering” undefined so an investor or an issuer cannot know whether an issuance is a public offering or a private offering just by reading the Securities Act.

However, the United States Supreme Court partially clarified section 4(2) by noting that its application turns on “whether the particular class of persons affected needs the protection of the Act.”²¹⁵ Where the transaction involves an offering made “to those who are shown to be able to fend for themselves,” it is not a public offering.²¹⁶ Moreover the Court appeared to set a standard for public offerings based on information availability: to apply the Private Offering exemption, the offerees must have access to the kind of information that would be disclosed in a securities registration statement.²¹⁷

The SEC has also provided its interpretation of section 4(2). In a statement that is of barely more help than reading section 4(2) itself, the SEC stated that to determine whether a transaction is a public offering, the complete context must be considered, “including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering.”²¹⁸

²¹¹ Securities Act of 1933 § 3(b) (2006).

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.* § 4(2).

²¹⁵ *Sec. & Exch. Comm’n v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).

²¹⁶ *Id.*

²¹⁷ *Id.* at 125-26.

²¹⁸ Non-Public Offering Exemption, Securities Act Release No. 4552, 1962 WL 69540, at *1 (Nov. 6, 1962).

Despite the uncertain understanding of “public offering” provided by the Supreme Court and the SEC with respect to section 4(2), the SEC’s adoption of Rule 506, discussed below, sheds more light on the interpretation of public offerings. It is important to note, however, that the Private Offering exemption of section 4(2) and the exemption under Rule 506 are considered to be separate exemptions, despite their apparent overlap.²¹⁹

d. *Section 4(6)*

The exemption provided for in this section, the Accredited Investor exemption, exempts transactions involving offers or sales to one or more accredited investors as long as three criteria are satisfied: (1) the aggregate offering price of the issue of the securities cannot exceed the amount allowed under section 3(b)²²⁰; (2) neither the issuer nor anyone acting on the issuer’s behalf engages in advertising or public solicitation related to the transaction; and (3) the issuer must file the type of notice required by the SEC at the time of the issuance.²²¹ In addition to the \$5,000,000 cap on the aggregate amount of the issuance and the prohibition against public solicitation, the most important aspect of the exemption is that it must be offered only to accredited investors, a term defined in section 2.²²²

2. *Regulation D*

Regulation D, an amalgam of rules adopted by the SEC to elucidate its position on limited offerings, has three rules that are especially pertinent to the discussion of exempting securities. Of those three, Rules 504 and 505 fall under the auspices of section 3(b) of the Securities Act and Rule 506 is a rule promulgated under section 4(2).²²³ Each rule will be discussed in turn.

a. *Rule 504*

Under Rule 504, offers and sales of securities are exempt if they meet several qualifications. First, the aggregate price offering is limited to \$1,000,000, less the aggregate amount of any securities sold within the twelve months of the start of and during any offer to sell securities under Rule 504 in reliance on an exemption under section 3(b) of the Security Act.²²⁴ Second,

²¹⁹ SODERQUIST & GABALDON, *supra* note 16, at 75.

²²⁰ See Securities Act of 1933 § 3(b) (2006). The amount in question, as explained previously, is five million dollars.

²²¹ Securities Act § 4(6).

²²² *Id.* See § 2(a)(15)(ii) for the definition of “accredited investor.”

²²³ SODERQUIST & GABALDON, *supra* note 16, at 83.

²²⁴ 17 C.F.R. § 230.504(b)(2).

the rule places no limitation on the number of investors, nor is there any qualification placed on the type of investors.²²⁵ As a default, general solicitation of purchasers is not permitted because Rule 504's provisions require that Rule 502(c)'s terms and conditions be followed.²²⁶ However, this limitation is lifted if (1) the securities are registered under a state law requiring public filing and a delivery of a disclosure document to investors before the sale, and that disclosure document is actually delivered²²⁷; or (2) the securities are sold under state law exemptions allowing for solicitations, but only when sold to accredited investors.²²⁸

Significantly, Regulation D shares the same definition of accredited investor as the Securities Act,²²⁹ but it is defined in Rule 501 rather than Rule 215, where the original definition of an accredited investor is found. The SEC considers an accredited investor to be, among other possibilities, (1) any director, executive officer, or general partner of the issuer of the securities or any director, executive officer, or general partner of a general partner of the issuer²³⁰; (2) any natural person with an individual net worth or a joint net worth with the individual's spouse that exceeds \$1,000,000 at the time of the security purchase²³¹; (3) any natural person with an individual income that exceeds \$200,000 in each of the past two years or a joint income with the individual's spouse that exceeds \$300,000 over the same period, and who has a reasonable expectation of obtaining that same income in the current tax year²³²; or (4) any entity in which only accredited investors own the equity.²³³

The last important requirement in order to cover securities under a Rule 504 exemption is the limitation on resale of the securities, as provided in the rule's requirement that 502(d)'s provisions relating to resales be followed.²³⁴ However, because language in Rule 504 provides exceptions to the application of Rule 502's restrictions,²³⁵ resales of securities exempted under Rule 504 often are not problematic. Here, it suffices to say that the securities may only be resold in public sales after certain criteria are met, particularly a one-year holding period requirement.²³⁶

²²⁵ SODERQUIST & GABALDON, *supra* note 16, at 84.

²²⁶ 17 C.F.R. § 230.504(b)(1). *See also id.* § 230.502(c).

²²⁷ *Id.* § 230.504(b)(1)(i)-(ii). *See also* SODERQUIST & GABALDON, *supra* note 16, at 84-85. Soderquist and Gabaldon provide a very useful table on pp. 84-85 that summarizes the requirements for exemptions under Rules 504, 505, and 506.

²²⁸ 17 C.F.R. § 230.504(b)(1)(iii).

²²⁹ *Id.* § 230.501(a).

²³⁰ *Id.* § 230.501(a)(4).

²³¹ *Id.* § 230.501(a)(5).

²³² *Id.* § 230.501(a)(6).

²³³ *Id.* § 230.501(a)(8).

²³⁴ *Id.* § 230.504(b)(1). *See also* 17 C.F.R. § 230.502(d).

²³⁵ *See* 17 C.F.R. § 230.504(b)(1).

²³⁶ SODERQUIST & GABALDON, *supra* note 16, at 85.

b. Rule 505

Like Rule 504, Rule 505 is also covered under section 3(b) of the Security Act.²³⁷ Securities are exempt under Rule 505 if several requirements are met. First, the aggregate price offering of securities under Rule 505 must not exceed \$5,000,000, less the aggregate amount of any securities sold within the twelve months of the start of and during any offer to sell securities under Rule 505 in reliance on an exemption under section 3(b) of the Security Act.²³⁸ Rule 505 also requires that the terms of Rules 501 and 502 be satisfied.²³⁹ The result is that no general solicitations of purchasers are allowed under Rule 505.²⁴⁰ Moreover, the resale of the securities in public sales is restricted.²⁴¹ Unlike Rule 504, Rule 505 places a restriction on the number of investors who can purchase securities in any offering, a number that is capped at thirty-five non-accredited investors,²⁴² plus an unlimited number of accredited investors.²⁴³ These investors also need not meet any particular qualifications under Rule 505 in order for the exemption to apply.²⁴⁴

c. Rule 506

The last of the pertinent Regulation D rules under the SEC exemptions, Rule 506, is a rule relating to the Securities Act § 4(2).²⁴⁵ Like Rule 505, Rule 506 requires that the terms and conditions of Rules 501 and 502 be satisfied.²⁴⁶ Also like Rule 505, Rule 506 caps the number of non-accredited investors who purchase securities in any offering at thirty-five,²⁴⁷ but allows for an unlimited number of accredited investors.²⁴⁸ Because of the application of Rule 502, Rule 506 also prohibits the general solicitations of purchasers by the issuer.²⁴⁹ Under the Rule 506 exemption, restrictions, too, are placed on the resale of the securities because of Rule 502's application.²⁵⁰

²³⁷ *Id.* at 83.

²³⁸ 17 C.F.R. § 230.505(b)(2)(i).

²³⁹ *Id.* § 230.505(b)(1).

²⁴⁰ *Id.* § 230.502(c).

²⁴¹ *Id.* § 230.502(d). *See also* Soderquist & Gabaldon, *supra* note 16, at 84.

²⁴² 17 C.F.R. § 230.505(b)(2)(ii).

²⁴³ SODERQUIST & GABALDON, *supra* note 16, at 84.

²⁴⁴ *Id.*

²⁴⁵ *Id.* at 83.

²⁴⁶ 17 C.F.R. § 230.506(b)(1).

²⁴⁷ *Id.* § 230.506(b)(2)(i).

²⁴⁸ SODERQUIST & GABALDON, *supra* note 16, at 84.

²⁴⁹ 17 C.F.R. § 230.506(b)(1). *See also id.* § 230.502(c).

²⁵⁰ 17 C.F.R. § 230.506(b)(2)(i). *See also id.* § 230.502(d).

There are two principal differences between Rules 505 and 506. Rule 506 places no limit on the aggregate amount of the offering price,²⁵¹ unlike Rule 505's \$5,000,000 limit.²⁵² Also, Rule 506 establishes certain qualifications that investors must meet if they are not considered accredited investors under Rule 501's definition of that term. Put simply, non-accredited investors must at least be sophisticated investors.²⁵³ Rule 506 explains that for a security to be exempt under the rule, each non-accredited investor must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," or the issuer must reasonably believe that each purchaser meets this requirement at a time just before the sale.²⁵⁴

There is another important piece of legislation that involves Rule 506. The National Securities Markets Improvement Act of 1996 (NSMIA) amended the Securities Act of 1933 to read that a security which was considered a "covered security" as defined by that Act was automatically exempt from state securities laws registration.²⁵⁵ Among those securities that are considered "covered" under NSMIA are securities issued in connection to a transaction that is exempt from registration under the Securities Act pursuant to rules promulgated by the SEC under section 4(2) of the Securities Act.²⁵⁶ By its own language, Rule 506 is an exemption for transactions pertaining to securities offerings under section 4(2) of the Securities Act.²⁵⁷ Hence, under NSMIA, those securities that are exempt pursuant to Rule 506 are automatically exempt from registration under state securities laws.

B. *Kentucky Exemptions from the Registration of Securities*

The process for considering the Kentucky exemptions is identical to that for considering the federal exemptions. Assuming that a share of a syndicated Thoroughbred is found to be an investment contract security to which the registration requirements would normally apply, section 292.340 expressly provides that those registration requirements need not apply if the security can be issued under an exemption.²⁵⁸ The purpose of this section will be to review those exemptions in two parts. Section III-B-1 will provide the

²⁵¹ SODERQUIST & GABALDON, *supra* note 16, at 84.

²⁵² 17 C.F.R. § 230.505(b)(2)(i).

²⁵³ *Id.*

²⁵⁴ 17 C.F.R. § 230.506(b)(2)(ii).

²⁵⁵ National Securities Markets Improvement Act (NSMIA) of 1996 § 102(a); Securities Act of 1933 § 18(a)(1)(A) (2006). Any future references to NSMIA will cite to the pertinent Securities Act sections rather than the NSMIA sections in order to maintain consistency when discussing the Securities Act, since the NSMIA in part, amended the Securities Act § 18.

²⁵⁶ Securities Act § 18(b)(4)(D).

²⁵⁷ 17 C.F.R. § 230.506(a).

²⁵⁸ Blue Sky Laws § 292.340 (West 2009).

exemptions set forth by the Kentucky General Assembly in the Blue Sky Laws, and Section III-B-2 will cover the exemptions provided for in the regulations issued by the Kentucky Department of Financial Institutions' Division of Securities.

Before discussing the specific Kentucky exemptions, it is important to stress again that NSMIA, passed by Congress in 2006, automatically exempts from state registration those securities that are covered securities.²⁵⁹ Among those covered securities are those exempted from registration under the Securities Act pursuant to SEC rules promulgated under section 4(2) of the Securities Act.²⁶⁰ This includes a Rule 506 exemption.²⁶¹ The result under Kentucky securities registration requirements is that a security that satisfies the Rule 506 exemption requirements is a covered security and is, therefore, automatically exempt from registration pursuant to Kentucky securities laws.²⁶² This point is reaffirmed by Kentucky Blue Sky Laws § 292.340, which states that covered securities are exempt from Kentucky registration requirements.²⁶³

1. The Kentucky Blue Sky Laws: Exemptions

a. Section 292.410

While this section provides exemptions for several types of securities, only one general subsection, section 292.410(1)(i), is really applicable for the purposes of syndicating Thoroughbreds. The section states that an offer or sale of a security by the security's issuer is exempt if several conditions are satisfied.²⁶⁴ For example, the issuer cannot use a general advertisement or general solicitation to offer or sell the securities.²⁶⁵ The issuer must also have a reasonable belief that each purchaser is buying the securities for investment and knows of the limitations placed on resale and transferability of the securities.²⁶⁶ Assuming the above two conditions are met, then the next condition can, in essence, be viewed as providing for three separate exemptions. First, there is an exemption if each purchaser can access all the material facts regarding the securities because of the purchaser's or his family member's active involvement in or management of the issuer.²⁶⁷ The second

²⁵⁹ Securities Act § 18(a)(1)(A).

²⁶⁰ *Id.* § 18(b)(4)(D).

²⁶¹ See 17 C.F.R. 230.506(a).

²⁶² See Securities Act § 18(a)(1)(A) & 18(b)(4)(D); 17 C.F.R. § 230.506(a).

²⁶³ Blue Sky Laws § 292.340.

²⁶⁴ *Id.* § 292.410(1)(i).

²⁶⁵ *Id.* § 292.410(1)(i)1.

²⁶⁶ *Id.* § 292.410(1)(i)2.

²⁶⁷ *Id.* § 292.410(1)(i)3a.

exemption applies when there are no more than fifteen purchasers in Kentucky described in subdivision a (the “insider” exemption) plus an unlimited number of accredited investors as defined by Rule 501 of the Securities Act of 1933.²⁶⁸ Lastly, the third exemption is applicable if the total offering price of the securities, including those sold outside Kentucky, is not more than \$1,000,000; there are no more than thirty-five non-accredited investors, including those purchasers outside Kentucky; and each purchaser either receives all material information with respect to the decision to invest or is an accredited investor, or is a person described in subdivision a (an “insider”).²⁶⁹

2. *The Kentucky Securities Regulations*

The two sections that follow contain exemptions promulgated by the Kentucky Department of Financial Institutions and are codified within the Kentucky Administrative Regulations.

a. *Section 10:210*²⁷⁰

This section provides state exemptions to those securities that are exempt from registration under the Securities Act pursuant to Federal Regulation D; specifically, the exemption applies to those securities that are offered or sold in compliance with Rules 504 and 505.²⁷¹ This exemption applies provided that the requirements of two other subsections are satisfied.²⁷² The issuer must not offer to sell or sell the security by means of a general advertisement or general solicitation except as allowed under Rule 504.²⁷³ Moreover, the issuer must reasonably believe that each purchaser who is purchasing the security within Kentucky is doing so for investment purposes²⁷⁴ and is aware of the limitations placed on resale and transferability of such securities.²⁷⁵ The issuer must also file a notice on Form D, either within fifteen days after the first sale of a security into or from Kentucky if sold pursuant to Rule 505,²⁷⁶ or at least ten days before the first sale into or

²⁶⁸ *Id.* § 292.410(1)(i)3b. *See supra* notes 230-33 and corresponding note text for the relevant definitions of “accredited investor.”

²⁶⁹ *Id.* § 292.410(1)(i)3c.

²⁷⁰ 808 KY. ADMIN. REGS. 10:210 (2000).

²⁷¹ *Id.* § 1(1).

²⁷² *Id.*

²⁷³ *Id.* § 1(3)(a).

²⁷⁴ The term “investment purposes” is defined in 808 KY. ADMIN. REGS. 10:160 § 1(2)(a)-(b). To be for investment, the security must be held for a year, must not have been purchased with view toward resale, and must not be disposed of if not registered or exempt. *Id.* § 1(2)(a)1-3. The buyer must be willing to bear the economic risk of the security for an indefinite period of time, and must not need the liquidity of the investment. *Id.* § 1(2)(b)1-2.

²⁷⁵ 808 KY. ADMIN. REGS. 10:210 § 1(3)(b)1a-1b.

²⁷⁶ *Id.* § 1(3)(c)1a.

from Kentucky if sold pursuant to Rule 504.²⁷⁷ The remainder of section 10:210 lays out the informational requirements that must be filed as well as the situations in which this exemption might be deemed not available.²⁷⁸ Because those provisions cover mainly minor details, they are left out of the discussion here.

b. *Section 10:340*²⁷⁹

This final state exemption applies to certain limited offerings that are offered only to accredited investors.²⁸⁰ The section begins by adopting the definition of an accredited investor as the term is defined in Rule 501 of Federal Regulation D.²⁸¹ The offering or sale must be made exclusively to a person who is an accredited investor.²⁸² The issuer must also believe that each purchaser is buying the security as an investment and not with a view toward resale.²⁸³ To qualify as a purchase for investment, the purchaser must hold the security for at least one year.²⁸⁴ If the purchaser does not, it will be presumed that the security was bought with a view to distribute.²⁸⁵ However, if the security is sold within one year to another accredited investor or pursuant to Kentucky registration requirements, the presumption of a purchase with view to distribute is not established.²⁸⁶

Also, the issuer may make a general announcement of the proposed offering provided that the issuer complies with certain restrictions on what information can be included in the announcement.²⁸⁷ Among the most important restrictions, the issuer must specifically state that the offering is only available to accredited investors and that money or other consideration may not be solicited or accepted.²⁸⁸

Conspicuously absent from this exemption are two things. First, the exemption does not place a limit on the aggregate price of the securities to be offered or sold.²⁸⁹ Second, the exemption places no limit on the number of

²⁷⁷ *Id.* § 1(3)(c)1b.

²⁷⁸ *See id.* § 1(3)-(4).

²⁷⁹ 808 KY. ADMIN. REGS. 10:340 (2000).

²⁸⁰ *Id.*

²⁸¹ *Id.* § 1. *See supra* notes 230-33 and corresponding note text for the relevant definitions of “accredited investor.”

²⁸² 808 KY. ADMIN. REGS. 10:340 § 2(1).

²⁸³ *Id.* § 2(3).

²⁸⁴ *Id.* § 2(3)(a).

²⁸⁵ *Id.*

²⁸⁶ *Id.*

²⁸⁷ *Id.* § 2(5)(a).

²⁸⁸ *Id.* § 2(5)(b)6a-b.

²⁸⁹ *See* 808 KY. ADMIN. REGS. 10:340.

investors who may purchase the securities.²⁹⁰ All that is required, as mentioned previously, is that each and every investor must be an accredited investor.²⁹¹

C. Applying the Exemptions to a Share of a Thoroughbred: Breeding and Racing Contexts

After discussing the exemptions from registration supplied by federal and Kentucky statutes and regulations, the second step of this paper's analysis can be completed by discussing the likely application of those exemptions to shares of syndicated Thoroughbreds in both breeding and racing contexts.

1. The Breeding Context

The finding of a security does not automatically trigger federal and Kentucky registration requirements because there is a wide range of exemptions available under which the issuers may avoid the federal and Kentucky registration requirements. However, in the context of syndicating Thoroughbreds for breeding, because no security has been found where the criteria of the Gainesway No-Action Letter is followed,²⁹² and because the United States Supreme Court, the Sixth Circuit Court of Appeals, and the Kentucky Federal District Courts have never found a share of a Thoroughbred syndicated for breeding purposes to be a security, it is not necessary to speculate at this point about the application of exemptions to shares of Thoroughbred stallions where those securities have never been found in Kentucky. Thus, it suffices simply to note that if a share of a Thoroughbred stallion is ever found to be an investment contract under *Howey*, then those sellers and buyers within Kentucky will need to consider the federal exemptions discussed above in Section III-A and the Kentucky exemptions discussed above in Section III-B as a means to avoid the securities registration requirements.

2. The Racing Context

Unlike the breeding context, the scenario for racing is quite different. Section II-C-2 above concluded that it is entirely possible that shares of a Thoroughbred syndicated during the horse's racing career will be considered securities under federal and Kentucky securities laws. Hence, they will be

²⁹⁰ *Id.*

²⁹¹ *Id.* § 2(1).

²⁹² Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with James Philpott, *supra* note 85. Both men stated that securities laws are not typically a concern within the breeding sector of the Thoroughbred industry so long as the Gainesway No-Action Letter criteria are followed.

subject to the registration requirements unless an exemption is applicable. Within the racing context, there are many possible exemptions available.

However, most of those exemptions, whether provided under federal or Kentucky law, suffer pitfalls that make them less than ideal in practice. Starting with the federal exemptions, an intrastate offering pursuant to section 3(a)(11) of the Securities Act would unduly restrict the potential investor pool to only those investors who share common state residence with the issuer,²⁹³ a burdensome outcome for a global sport. A section 4(2) private offering is discriminated against because of its ambiguity; a Rule 506 exemption, which is promulgated under section 4(2), is easier to understand and to satisfy.²⁹⁴ The main problem with the section 4(6) exemption is that it limits the offering only to accredited investors and caps the aggregate amount at \$5,000,000.²⁹⁵ This is fine for racing syndicates if they prefer, but the Rule 506 exemption gives them more options by allowing them to include unaccredited investors and to offer an uncapped aggregate amount of securities.²⁹⁶ Rules 504 and 505 are also both available, but their downfall is that they cap the total amount of any securities available to be offered by the issuer under the 504 and 505 exemptions within the prior twelve months.²⁹⁷ This places severe restrictions on the total number of horses that can be syndicated by an issuer under Rules 504 and 505 within a twelve-month period.²⁹⁸

The Kentucky exemptions are equally inadequate for racing syndicates because they would have to be used in conjunction with the federal exemptions, none of which are likely to be used other than Rule 506—as will be explained below. For example, Kentucky securities regulation section 10:210 is applicable only for securities offered under Rules 504 and 505.²⁹⁹ These have been shown already to be less than ideal exemptions on which issuers can rely. Moreover, section 10:340 of the Kentucky securities regulations is extremely similar to the federal section 4(6) exemption, and suffers the same drawbacks. While it does have an uncapped offering amount, section 10:340 is only available to accredited investors, which limits the potential investor pool that racing syndicates can tap.³⁰⁰

The Kentucky statutory exemptions also provide little help. Section 292.410(1)(i)3c is largely similar to Rule 505 and 506, but it places a

²⁹³ Securities Act § 3(a)(11).

²⁹⁴ 17 C.F.R. § 230.506(a).

²⁹⁵ Securities Act of 1933 § 4(6) (2006).

²⁹⁶ SODERQUIST & GABALDON, *supra* note 16, at 84.

²⁹⁷ 17 C.F.R. § 230.504(b)(2) & (b)(2)(i).

²⁹⁸ *Id.* The limits are \$1,000,000 under Rule 504 and \$5,000,000 under Rule 505.

²⁹⁹ 808 KY. ADMIN. REGS. 10:210.

³⁰⁰ 808 KY. ADMIN. REGS. 10:340.

\$1,000,000 cap on the amount of offering allowed.³⁰¹ The next statutory exemption basically applies only to those purchasers who are actively involved in managing the organization.³⁰² This exemption unfortunately does not work for the syndicates, whose business model logically requires outside investors. Finally, the last relevant Kentucky statutory exemption includes no more than fifteen insiders of the issuer who are located within Kentucky as well as an unlimited number of accredited investors.³⁰³ The benefit here is that there is no cap placed on the total aggregate amount permitted to be offered. But again, the restrictions on who may purchase under the exemptions are stringent.

Despite the shortcomings of most of the exemptions, there still are two very good options for addressing the securities law issues with respect to syndicating a Thoroughbred in the racing context. The first option is through the use of a member-managed LLC. Kentucky Securities Regulations provide a safe harbor under which membership interests in *member-managed* LLCs automatically do not classify as securities.³⁰⁴ The benefit of using this safe harbor is that fulfilling the provisions of section 10:360 means that the membership interests are essentially not securities under federal law, and so there is no need for issuers to use an exemption from federal securities registration requirements.³⁰⁵ There are potential drawbacks to section 10:360, however. The number of investors is capped at thirty-five,³⁰⁶ and the investor-members must either actively participate in management³⁰⁷ or must be able to remove the managing member by vote.³⁰⁸ Because the issuer-promoters typically maintain full control over the management of the Thoroughbred's racing career, the best way to fall under the section 10:360 safe harbor is by allowing members to remove the managing member by vote.³⁰⁹

The biggest point of controversy for section 10:360 stems from the jurisdiction of incorporation. A member-managed LLC incorporated in Kentucky has no problem availing itself of the section 10:360 safe harbor. However, there is uncertainty surrounding its availability for member-managed LLCs incorporated in jurisdictions other than Kentucky. For example, where a member-managed LLC is incorporated in another jurisdiction but all of its members are Kentucky residents, the section 10:360

³⁰¹ Blue Sky Laws § 292.410(1)(i)3c (West 2009).

³⁰² *Id.* § 292.410(1)(i)3a.

³⁰³ *Id.* § 292.410(1)(i)3b.

³⁰⁴ 808 KY. ADMIN. REGS. 10:360.

³⁰⁵ Telephone Interview with Robert Beck, *supra* note 79.

³⁰⁶ 808 KY. ADMIN. REGS. 10:360 § 1.

³⁰⁷ *Id.* § 1(1).

³⁰⁸ *Id.* § 1(2).

³⁰⁹ Telephone Interview with Robert Beck, *supra* note 79.

safe harbor is available.³¹⁰ It is not certain, though, whether that safe harbor is available to non-Kentucky resident members bringing suit in the jurisdiction of incorporation where a member-managed LLC is incorporated in a non-Kentucky jurisdiction and membership is split between Kentucky and non-Kentucky residents.³¹¹

It is evident that if the issue of availability of section 10:360 in other jurisdictions can be avoided, the safe harbor is a very effective option for syndicating racehorses in Kentucky. So long as the members can either actively participate in management or can remove the managing member, their interests are automatically deemed not to be securities under the Kentucky laws.³¹² In practice, satisfaction of the section 10:360 requirements also implies that the membership interests will not be securities under federal laws and so there is no need for issuers to rely on federal exemptions.³¹³

Unfortunately, the uncertainty as to section 10:360's availability for non-Kentucky residents when the LLC is incorporated outside Kentucky creates a big potential problem considering the tendency for racing syndicates to pull investors from multiple states. If there is the possibility that the 10:360 safe harbor cannot be used outside Kentucky with non-Kentucky residents, then issuers who do not incorporate the member-managed LLCs in Kentucky could be forced to find exemptions from the securities registration requirements of each state where its investors are residents as well as an exemption from federal securities registration requirements.

To circumvent the problem of having to find several different state and federal exemptions, the securities or interests can simply be sold pursuant to a Rule 506 exemption, which automatically exempts the securities from both federal and state securities laws' registration requirements.³¹⁴ Because of this simple solution, the Rule 506 exemption, the second option referred to above for syndicating a Thoroughbred for racing, seems to be the best option for syndicates selling interests in Kentucky. Aside from Rule 506's biggest benefit, its automatic exemption from both federal and Kentucky securities registration requirements,³¹⁵ there is also no dollar amount restriction placed

³¹⁰ Telephone Interview with Robert Beck, Member, Stites & Harbison (Mar. 3, 2010).

³¹¹ *Id.*

³¹² 808 KY. ADMIN. REGS. 10:360 §§ 1(1)-(2).

³¹³ Telephone Interview with Robert Beck, *supra* note 79.

³¹⁴ See Securities Act of 1933 § 18(a)(1)(A) & 18(b)(4)(D) (2006); Blue Sky Laws § 292.340 (West 2009); 17 C.F.R. § 230.506(a).

³¹⁵ See Securities Act § 18(a)(1)(A) & 18(b)(4)(D); Blue Sky Laws § 292.340; 17 C.F.R. § 230.506(a).

on the aggregate amount of the securities offering,³¹⁶ which means that racing syndicates are capable of selling shares of as many horses as they can without regard for timing issues. The only major constraint is the syndicates' financial ability to purchase up front the horses in which they later syndicate by selling interests to investors.

One limitation of Rule 506 is that the syndicates cannot offer or sell the securities by general solicitation or general advertisement.³¹⁷ Another is that the exemption restricts the selling of shares to no more than thirty-five investors plus an unlimited number of accredited investors.³¹⁸ Where those investors are not accredited, they must be sophisticated, however. This means that they must have sufficient knowledge and experience of business and financial matters to be able to evaluate the risks and benefits of the potential investment.³¹⁹

Some of the triggering mechanisms that defeat a Rule 506 exemption can also be sidestepped relatively easily. For example, a general advertisement or general solicitation can be avoided by, for example, placing restrictions on the syndicate website that permit only those attesting to be accredited investors to view the roster of horses that are available for syndication and the details of the syndication procedure.³²⁰ Additionally, the typical percentage ownership standards of two-and-a-half percent, five percent, or ten percent³²¹ necessarily caps the maximum number of shareowners for any given horse at forty. This is well within the reach of the Rule 506 exemption, especially if the racing syndicate targets mainly accredited investors, whose number can be unlimited under Rule 506.³²²

To summarize, the Rule 506 exemption as a whole appears to be more beneficial than the other exemptions and safe harbors. The exemption allows non-accredited purchasers to invest in syndicated shares of Thoroughbred racehorses.³²³ It has no limit on the amount of securities offered, and it ensures the syndicates that at the very least, all the investors will be sophisticated, if not accredited.³²⁴ Most importantly, a sale of securities pursuant to Rule 506 automatically exempts the securities from the federal and the Kentucky registration requirements.³²⁵ Thus, assuming that

³¹⁶ See 17 C.F.R. § 230.506. The title of the rule indicates that it applies to "Sales Without Regard to Dollar Amount."

³¹⁷ *Id.* § 230.502(c).

³¹⁸ SODERQUIST & GABALDON, *supra* note 16, at 84.

³¹⁹ 17 C.F.R. § 230.506(b)(2)(ii).

³²⁰ Telephone Interview with Joshua Cooper, *supra* note 84.

³²¹ *Id.*

³²² SODERQUIST & GABALDON, *supra* note 16, at 84.

³²³ *Id.*

³²⁴ 17 C.F.R. § 230.506(b)(2)(ii).

³²⁵ See Securities Act of 1933 § 18(a)(1)(A) & 18(b)(4)(D) (2006); Blue Sky Laws § 292.340 (West 2009); 17 C.F.R. § 230.506(a).

shares of Thoroughbreds used for racing are found to be securities, the racing syndicates can still avoid federal and Kentucky securities registration requirements if they can offer or sell the securities pursuant to a Rule 506 exemption.

IV. CONCLUSION

The sport of kings has a very long and distinguished past. As the Thoroughbred breed has developed with the sport of horseracing itself, two segments of the industry have evolved—breeding and racing. The evolution of those two segments has resulted in the concept of syndication, the selling of fractional interests in the Thoroughbreds.³²⁶ A logical result of syndication, then, is the analysis of whether those fractional interests constitute securities that are subject to federal and state securities laws.

This note first examined the federal and Kentucky definitions of a security, in particular their respective definitions of an investment contract. It then superimposed those tests onto shares of syndicated Thoroughbreds in both the breeding and racing contexts to determine whether those shares would be considered securities. The note then discussed the federal and Kentucky exemptions under which securities could avoid registration. Finally, these exemptions were applied to syndicated Thoroughbred shares in both the breeding and racing contexts.

On the breeding side, the syndication of stallions has been the direct result of the efforts of breeding farms to reduce their exposure to risk and to ensure a consistent book of mares to be bred to the stallions on the farms.³²⁷ For the investors of the shares of Thoroughbreds syndicated for breeding, the right to breed a mare to that stallion has been the principal reason for the investment. As a result, the SEC has set forth guidelines in its oft-cited Gainesway No-Action Letter that describes what criteria must be met to avoid having stallion shares be considered securities.³²⁸ Moreover, no Kentucky federal or state court has ever found the share of a Thoroughbred stallion to be a security.³²⁹ Thoroughbred industry participants have also stated that compliance with the Gainesway No-Action Letter will keep investors and syndicates from having their shares classified as securities.³³⁰

³²⁶ Sweeney, *supra* note 139, at 422.

³²⁷ Telephone Interview with Doug Cauthen, *supra* note 140.

³²⁸ Gainesway, *supra* note 153, at *3.

³²⁹ See, e.g., *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8, 9 (E.D. Ky. 1985).

³³⁰ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with James Philpott, *supra* note 85.

The racing context is quite the opposite. Syndicates claim to sell the shares purely for entertainment value and not for profit.³³¹ Investors, on the other hand, likely have some hope or expectation of earning a positive financial return on their investments. And while there is no case law on point in Kentucky, an SEC no-action letter, the Star Recruit No-Action Letter, strongly suggests that syndicating a Thoroughbred during his racing career could result in a finding that the shares of that Thoroughbred are securities under both federal and state securities laws.³³² However, even if those shares are found to be securities, syndicates can attempt to make use of the many federal and state exemptions to avoid registering those securities. In the opinion of the author (supported by at least one syndicate), the best exemption is a Rule 506 exemption, which has the effect of exempting the securities from both federal and state registration requirements.³³³ Moreover, Rule 506's non-imposition of a limit on the amount of securities permitted to be offered and its allowance for thirty-five non-accredited (but sophisticated) investors and an unlimited number of accredited investors³³⁴ has two effects: (1) it increases the potential pool of investors a syndicate can interact with while ensuring that none of the investors are in over their heads; and (2) it allows a syndicate to sell shares of as many racehorses as it is financially able to do without regard to constraints on timing or aggregate offering amounts.

Significantly, regardless of whether investors participate in horseracing on the breeding side or the racing side, they must be aware of the potential securities law implications to their purchases. While the sport is at first glance full of glamour and excitement, it also plays host to some incredibly complex laws that must not be left at the gate when the horses break.

³³¹ Telephone Interview with Joshua Cooper, *supra* note 84; Telephone Interview with Barry Irwin, *supra* note 174.

³³² See Star Recruit, *supra* note 190.

³³³ See Securities Act of 1933 § 18(a)(1)(A) and 18(b)(4)(D) (2006); Blue Sky Laws § 292.340 (West 2009); 17 C.F.R. § 230.506(a).

³³⁴ SODERQUIST & GABALDON, *supra* note 16, at 84. See also 17 C.F.R. § 230.506.